

***United States Court of Appeals
for the Second Circuit***



APPELLEE'S BRIEF

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

77-6034

Nos.

77-6038, 77-6040, 77-6044, 77-6045, 77-6048, 77-6065

In re

WEIS SECURITIES, INC.,

Debtor.

GEORGE D. ALDRICH, et al.,

Appellants,

v.

EDWARD S. REDINGTON, Trustee, and SECURITIES
INVESTOR PROTECTION CORPORATION,

Appellees.

Appeal from the United States District Court for the
Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

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The federal policy of customer protection embodied in the Securities Exchange Act, and the rules thereunder, relating to the financial responsibility of broker-dealers, requires that, in the liquidation of an insolvent brokerage firm, subordinated lenders of the firm not be permitted to rescind subordination agreements, even if fraudulently procured, where rescission would adversely affect customers' claims	
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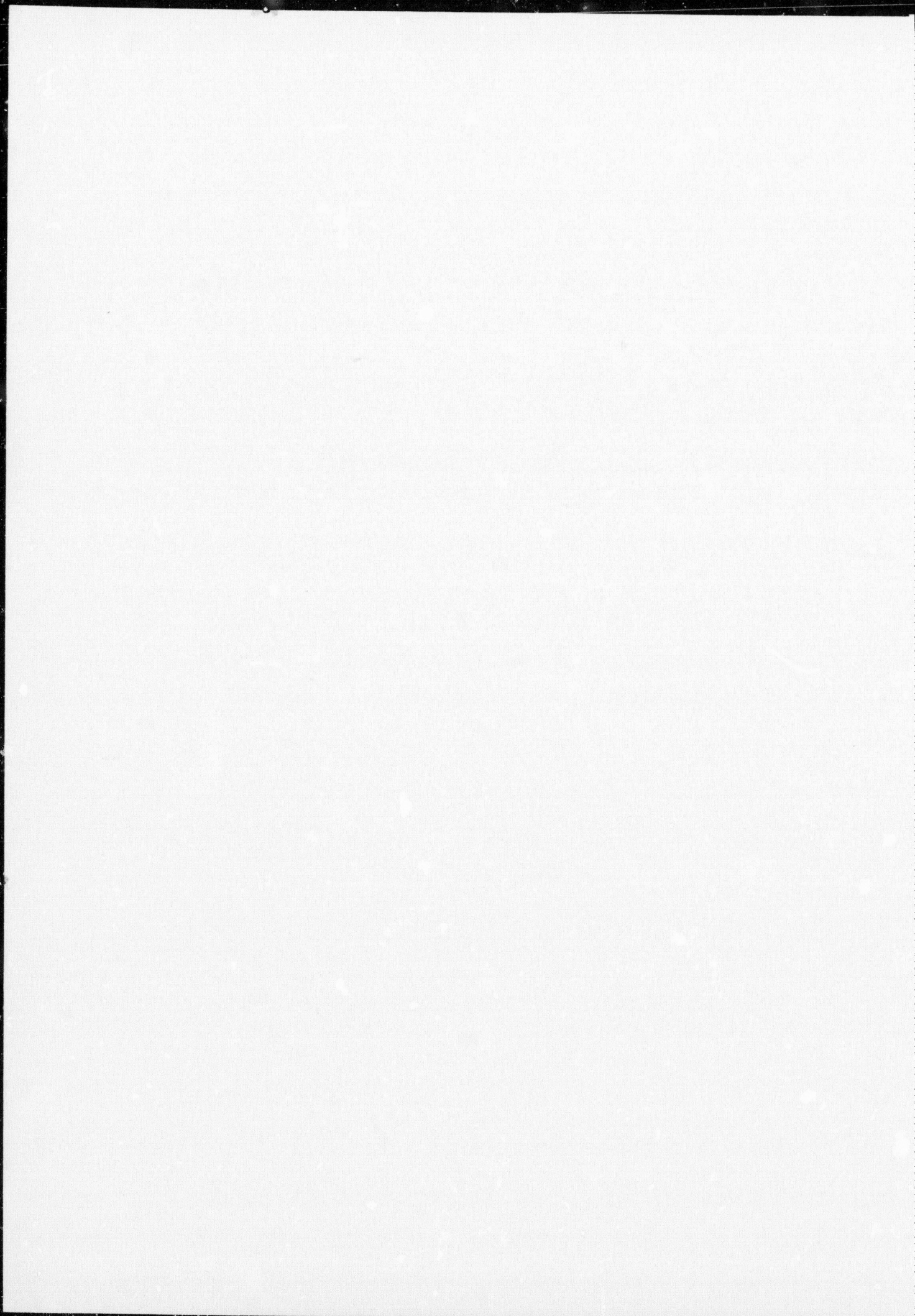
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BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE 1/

PRELIMINARY STATEMENT

Although this proceeding originated as an enforcement action brought by the Securities and Exchange Commission ("Commission") against Weis Securities, Inc. ("Weis"), 2/ once a broker-dealer in securities registered with the Commission,

1/ As a party below, the Commission is a party to this appeal. See East v. Crowds, 302 F.2d 645, 646-647 (C.A. 8, 1962).

2/ Securities and Exchange Commission v. Weis Securities, Inc., et al., S.D. N.Y., No. 73 Civ. 2332 (May 23, 1973).

as a result of Weis' irreparable financial condition and the harm to investors it could have engendered, the Securities Investor Protection Corporation ("SIPC") interceded in the action, seeking the appointment of a trustee and the orderly liquidation of the remaining assets of Weis. Both requests of SIPC were granted.

These are appeals from an order entered by the United States District Court for the Southern District of New York (per Wyatt, J.) on January 20, 1977, in connection with the liquidation of Weis. 3/ The lower court's order granted a motion for summary judgment made by the Weis trustee, and effectively precluded certain subordinated lenders from rescinding their agreements with Weis to subordinate their claims against Weis to the claims of Weis' customers and general creditors. In granting the trustee's motion for summary judgment, the court below reversed a prior decision of the bankruptcy judge assigned to this matter. 4/

COUNTERSTATEMENT OF THE QUESTION ADDRESSED

In liquidating an insolvent securities brokerage firm pursuant to the Securities Investor Protection Act of 1970 ("SIPA"), did the lower court err in precluding subordinated lenders to the insolvent firm from rescinding their subordination agreements, where it was undisputed that rescission of those agreements would have adversely affected the claims of the firm's customers?

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- 3/ The decision is reported at 425 F. Supp. 212, and may be found at A406 of the joint appendix on this appeal.
- 4/ The bankruptcy judge's opinion is reported at [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,666 (Bkrptcy. Ct., Jul. 15, 1976), and may be found at A379 of the joint appendix.

COUNTERSTATEMENT OF THE CASE 5/

The Commission instituted this action in the court below by filing a complaint seeking to enjoin Weis and others, inter alia, from continuing violations of the antifraud and net capital provisions of the Securities Exchange Act of 1934, 6/ and the Commission's rules thereunder. 7/ In addition to the entry of an injunction, the Commission requested the appointment of a temporary receiver for the assets and books and records of Weis. Immediately after the filing of that action, at the request of the SIPC, the court below appointed a trustee to oversee the orderly liquidation of the remaining assets of Weis, after determining that Weis' irreparable financial condition made clear the need of Weis customers for the statutory protections of SIPA. See SIPA §5(b), 15 U.S.C. 78eee(b).

Fifty-two subordinated lenders filed claims in the Weis liquidation proceeding, and, in April, 1974, the trustee filed an application seeking to have the bankruptcy court rule that those claims should be allowed only in accordance with their terms as subordinated loans. Although a majority of those lenders did not object to such treatment, twenty-three lenders challenged the validity of the subordination agreements and sought to rescind their agreements, claiming that they had been fraudulently induced to enter into those agreements in violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, 17 CFR 240.10b-5.

The trustee objected to those claims for rescission (A231-A259), and moved for summary judgment (A260-A305). In affidavits supporting his motion, the trustee set forth, among other things, facts relating to the subordination agreements in question and urged that those subordinated loans were properly considered

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- 5/ The background of this case is also set forth at pages 2-9 of the joint brief of the appellants and pages 4-11 of the appellees' joint brief.
- 6/ Sections 10(b) and 15(c)(3), 15 U.S.C. 78j(b) and 78o(c)(3).
- 7/ Rules 15c3-1, 17a-3, 17a-4, 17a-5 and 17a-11, 17 CFR 240.15c3-1, 240.17a-3, 240.17a-4, 240.17a-5, 240.17a-11.

part of Weis's capital by the appropriate regulatory authorities—the Commission and the New York Stock Exchange. None of the affidavits filed in opposition to the trustee's motion disputed any of the material facts.

The bankruptcy judge before whom the trustee's summary judgment motion initially was heard explicitly recognized that the subordinated lenders should be estopped from repudiating their subordination agreements if the customers and general creditors of Weis relied on those subordination agreements, or upon the net capital rules of the Commission and of the New York Stock Exchange, in transacting business with Weis. 8/ The bankruptcy judge denied the trustee's motion for summary judgment, however, believing it necessary to hold an evidentiary hearing to determine whether each and every one of Weis' 30,000 customers and its creditors had so relied; and, the bankruptcy judge held that this evidentiary hearing should precede any attempt to call upon the subordinated lenders to prove that they had, in fact, been fraudulently induced to subordinate the debts owed to them by Weis. 9/

The district judge reversed. After reviewing the purpose of the net capital rules (A408), he concluded that it was not necessary to show actual reliance on the subordination agreements by all customers and creditors of Weis because they "knew, or [are] presumed to have known, that the broker-dealer business of Weis was regulated by federal law and that as part of such regulation the net capital rule was enforced" (A418). He noted: "The subordinated lenders, by their agreements, enabled Weis to comply with the net capital rule and thus

8/ [1976--1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,666 at p. 90,276.

9/ The bankruptcy judge's opinion did not, however, indicate the type of reliance which must be established, nor did it distinguish Weis 30,000 customers, or their subrogee, SIPC, from the general creditors of Weis. Under Section 6(f)(1) of SIPA, 15 U.S.C. 78fff(f)(1), SIPC is subrogated to the claims of customers to the extent it advances funds to satisfy their claims.

to continue in business" (A419). Accordingly, he held that, "[u]nder the circumstances, actual reliance is not required to be shown"—that reliance "should be presumed as a matter of law" (*id.*). 10/

INTEREST AND POSITION OF THE
SECURITIES AND EXCHANGE COMMISSION

Pursuant to its responsibility to administer and enforce the federal securities laws, the Commission, among other things, regulates and monitors the financial soundness of brokers and dealers in the securities markets. 11/

The Commission submits this brief in support of the appellees, Edward S. Redington, the trustee for the liquidation of Weis, and SIPC, in response to these appeals. The district judge's decision properly and logically flows from the financial responsibility rules regulating broker-dealers, and particularly the net capital rule, which are designed, *inter alia*, to assure public confidence in dealings with securities brokers, and should be affirmed. 12/

10/ The district judge held that the procedure contemplated by the bankruptcy judge—of a protracted hearing on the reliance of more than 30,000 individuals—was both "illogical and unworkable" (A414).

11/ See Securities Exchange Act Sections 8(b) and 15(c)(3), 15 U.S.C. 78h(b) and 15 U.S.C. 78o(c)(3), and Securities Exchange Act Rule 15c3-1 thereunder, 17 CFR 240.15c3-1. These provisions are discussed *infra*, pp. 7-9.

12/ We respectfully disagree with that portion of the lower court's decision holding that the general creditors of Weis should also be accorded a priority over Weis's subordinated lenders (A419). But, as a practical matter, this issue appears to be moot. See discussion at pp. 19-20, *infra*.

ARGUMENT

THE FEDERAL POLICY OF CUSTOMER PROTECTION EMBODIED IN THE SECURITIES EXCHANGE ACT, AND THE RULES THEREUNDER, RELATING TO THE FINANCIAL RESPONSIBILITY OF BROKER-DEALERS, REQUIRES THAT, IN THE LIQUIDATION OF AN INSOLVENT BROKERAGE FIRM, SUBORDINATED LENDERS OF THE FIRM NOT BE PERMITTED TO RESCIND SUBORDINATION AGREEMENTS, EVEN IF FRAUDULENTLY PROCURED, WHERE RESCISSION WOULD ADVERSELY AFFECT CUSTOMERS' CLAIMS.

- A. The rules relating to the financial responsibility of broker-dealer firms, including the net capital requirements, are an integral and important part of the statutory scheme for the protection of customers who deal with such firms.

The Securities Exchange Act was enacted in response to "the speculative orgy of 1928 and 1929", 13/ and a presidential call for securities "legislation [that] has teeth in it." 14/ Among the abuses which the Act was intended to correct were the evils associated with excess credit in the securities industry, 15/ including the danger of customer losses resulting from the financial failures of over-extended broker-dealers. 16/ In response to that danger, Congress enacted a net capital provision, and authorized the Commission to promulgate financial responsibility rules applicable to broker-

13/ S. Rep. No. 1455, 73d Cong., 2d Sess., 81 (1934).

14/ H.R. Rep. No. 1383, 73d Cong., 2d Sess., 2 (1934).

15/ S. Rep. No. 1455, 73d Cong., 2d Sess., 12-13 (1934).

16/ In the discussion of the draft bill which became the Securities Exchange Act, it was noted that

"the four biggest failures in the Street * * * were cases where, insofar as their brokerage accounts were concerned, the houses were perfectly solvent. But their assets were involved in positions in securities which they had sponsored or in which they were interested, and when they were wiped out in their positions in such securities the bankruptcy pulled the brokerage clients down with them."

Senate Hearings on Stock Exchange Practices, 73d Cong., 1st Sess., pt. 15, 6522 (1934) (statement of T. Corcoran).

dealers doing business on a stock exchange. 17/ "Congress did not intend to permit a broker-dealer to continue operations unless he had on hand cash or liquid assets in the required ratio to aggregate indebtedness." H.R. Rep. No. 1613, 91st Cong., 2d Sess., 12 (1970); Securities and Exchange Commission v. General Securities Co., 216 F. Supp. 350 (S.D. N.Y., 1963); In re John W. Yeaman, Inc., Securities Exchange Act Release No. 7527 (Feb. 10, 1965).

In the early 1940's, pursuant to Section 15(c)(3) of the Securities Exchange Act, the Commission adopted Rule 15c3-1, which established a net capital requirement for those broker-dealers doing business in the over-the-counter market. 18/ In announcing its rule, the Commission stated: "The need for general rules to achieve customer protection against financially unsafe brokers and dealers has been apparent to us for some time * * * ." 19/ The net capital requirement

17/ Section 8(b) of the Securities Exchange Act, as originally enacted in 1934. Section 8(b) was deleted from the Act by the Securities Act Amendments of 1975, and was replaced with provisions granting general rulemaking authority to the Commission covering the entire spectrum of the financial responsibilities of all broker-dealers. Pub. L. No. 94-29 (June 4, 1975), 89 Stat. 109.

Thomas Corcoran, one of the drafters of the Act had explained: "This is a provision to make certain that brokers do not operate on a shoestring and that there is a capital cushion for their customers." Senate Hearings on Stock Exchange Practices, 73d Cong., 1st Sess., pt. 15, 6502 (1934).

18/ In 1938, Congress passed the Maloney Act, which amended the Securities Exchange Act to provide, inter alia, for financial responsibility rules for over-the-counter broker-dealers. As a result of the 1975 amendments to the Act, Section 15(c)(3), which was added to the Act in 1938, has replaced former Section 8(b) as the principal source of Commission authority to prescribe net capital requirements of all registered broker-dealers, regardless of whether they are members of a registered securities exchange.

Rule 15c3-1 was adopted in 1942, but its effectiveness was stayed. Securities Exchange Act Release No. 3322 (Oct. 29, 1942). It became effective in 1944 after certain definitions were added. Securities Exchange Act Release No. 3602 (Aug. 11, 1944). At that time the Commission provided that compliance with the net capital rules of the New York Stock Exchange and other named exchanges would constitute compliance with the Commission's regulations. See Securities Exchange Act Release No. 3617 (Nov. 8, 1944).

19/ Securities Exchange Act Release No. 3322, at 5 (Oct. 29, 1942).

"will provide a minimum cushion of 5% of the aggregate indebtedness of the broker or dealer as a margin of safety to his customers." 20/

The net capital rule is the "principal regulatory tool" employed by the Commission in monitoring the financial soundness of brokers and dealers. 21/ It has been described as "the most important weapon in the Commission's arsenal to protect investors." 22/ Thus, under the pervasive regulatory scheme by which compliance with the net capital rule is monitored, a broker-dealer is required to give telegraphic notice to the Commission on the day on which its net capital reserve falls below the minimum required by the rule. 23/ In short, the liquidity

20/ Id. at 7 (emphasis added).

21/ [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶79,174 at p. 82,578 (Jan. 10, 1973) (remarks of Senator Harrison A. Williams, Chairman of Senate Securities Subcommittee).

22/ Blaise D'Antoni & Associates v. Securities and Exchange Commission, 289 F.2d 276, 277 (C.A. 5), certiorari denied, 368 U.S. 899 (1961); accord, Hughes v. Dempsey-Taylor Co., 534 F.2d 156, 173 (C.A. 9), certiorari denied, 429 U.S. 896 (1976). See also, Securities and Exchange Commission, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 231, 92d Cong., 1st Sess. 49 (1971) [Study of Unsafe and Unsound Practices]:

"The principal method by which the regulatory bodies have attempted to protect investors with regard to the financial responsibilities of broker-dealers has been the maintenance of an adequate net capital base relative to the firms' aggregate indebtedness to assure that firms have sufficient liquid assets to cover their current indebtedness" (footnote omitted).

23/ Within 24 hours of falling below the minimum net capital requirements, the broker-dealer must provide the Commission with appropriate filings and with any supplementary information that the Commission may require. Securities Exchange Act Rule 17a-11(a)(1), (2), 17 CFR 240.17a-11(a)(1), (2). Similarly, when a broker-dealer finds that his net capital ratio falls below 12:1 or its total net capital is less than 120 percent of minimum net capital required, the broker-dealer will have to file a report of its financial condition. Rule 17a-11(b), 17 CFR 240.17a-11(b). If a broker-dealer fails to make and keep current books, he must give "immediate" telegraphic notice to the Commission and file a report within 24 hours stating what steps have been taken to correct the situation. Rule 17a-11(c), (d), 17 CFR 240.17a-11(c), (d).

requirements of the net capital rule serve as an early warning system for customer protection. 24/ These rules are strictly enforced even though it is conceivable that:

"a broker-dealer having net capital less than the minimum required by applicable rules might meet his current obligations [since] * * * the stringency of the requirement is designed to provide customers with an extra cushion." Securities and Exchange Commission Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 231, 92d Cong., 1st Sess. 15 n. 16 (1971).

A failure to comply with the provisions of the net capital rule may precipitate a liquidation of a broker-dealer. Where the court determines that the "customers of such members * * * are in need of protection," such a failure may precipitate a liquidation under the SIPA. See SIPA §§5(a)(1), (2), and (b)(1)(A)(iv), (v), 15 U.S.C. 78eee(a)(1), (2) and (b)(1)(A)(iv), (v); Securities and Exchange Commission v. Alan F. Hughes, Inc., 461 F.2d 974, 980-981 (C.A. 2, 1972).

At the time the subordination agreements involved in this appeal were entered into, the Commission had no uniform net capital rule applicable to all broker-dealers. Weis, however, was subject to the net capital requirements of New York Stock Exchange Rule 325, 25/ the violation of which would result in the suspension of its membership from that Exchange. 26/

24/ Hearings on H.R. 13308, 17585, 18081, 18109, 18458, Before Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 91st Cong., 2d Sess., 372 (1970). [Hearings on H.R. 13308, et al.] Additional protection is afforded by other financial responsibility rules such as Rule 15c3-3, 17 CFR 240.15c3-3 (segregation of customers' assets which are fully paid), and Rules 17a-3 and 17a-4, 17 CFR 240.17a-3 and 17a-4 (preservation of records and reports and notices).

25/ Under Section 6(d) of the Securities Exchange Act, 15 U.S.C. 78f(d), a national securities exchange was permitted to promulgate minimum financial responsibility rules. As we have noted supra, p. 7 n. 18, the Commission exempted from compliance with its net capital rule members of the New York Stock Exchange and other named exchanges in the belief that their net capital rules were "more comprehensive." Securities Exchange Act Release No. 3617 (Nov. 8, 1944). Today, all broker-dealers must comply with the Commission's Rule 15c3-1. See Securities Exchange Act Release No. 11499 (June 26, 1975), 7 SEC Docket 282 (July 15, 1975).

26/ Members of the Exchange are required, under its present Rules 327 and 416, to provide the Exchange with monthly reports stating their net capital and net capital ratios.

Both the Commission's and the Exchange's net capital rules permit a broker-dealer, in meeting net capital requirements, to treat cash and securities procured through subordinated loans—that is, borrowings which are subordinated to the claims of all present and future creditors pursuant to a satisfactory subordination agreement—as part of its capital, and not to include such loans as liabilities. Study of Unsafe and Unsound Practices at 56-57; Securities Exchange Act Release No. 8024 (Jan. 25, 1967). 27/

For subordinated loans to serve as a realistic component of a broker-dealer's capital assets, they must evince a continuous contribution to capital. For this reason, the Commission's net capital rules strictly prescribe the circumstances under which such loans can be called. 28/ Moreover, a significant requirement of a "satisfactory subordination agreement" is that the agreement be a binding and enforceable written agreement, and, at least since 1971, the Commission has required that such subordination agreements

27/ See New York Stock Exchange Rule 325.20(4) and Securities Exchange Act Rule 15c3-1(c)(1)(x), 17 CFR 240.15c3-1(c)(1)(x). Appendix D to Commission Rule 15c3-1 sets out the current requirements for satisfactory subordination agreements. The particular provisions, relevant to this case, are essentially identical to the version of Rule 15c3-1 in effect during the period in which the subordination agreements, which are the subject of this appeal, were entered into. While Weis was not subject to Rule 15c3-1 at that time, the Exchange rule was presumed to be at least as strict as the Commission's rule.

28/ See, e.g. Rules 15c3-1d(b)(7) (permissive repayment), (8) (suspended repayment), (9) (accelerated maturity-obligation to remain subordinated), (10) (accelerated maturity on event of default, obligation to remain subordinated), and (c)(1) (prohibited cancellation), 17 C.F.R. 240.15c3-1d(b)(7), (8), (9), (10) and (c)(1).

"provide that [the loan] may not be repaid or the agreement in any way terminated, rescinded or modified by mutual consent or otherwise if the effect would be to put the broker-dealer out of compliance with the 'net capital' requirements of the rule" (emphasis added). 17 CFR 240.15c3-1(c) (7)(iii). 29/

The purpose of this provision is to insure the permanency of subordinated capital in the brokerage industry. Thus, because they are analogous to a firm's equity, subordinated loans are enforced by bankruptcy courts regardless of whether or not senior creditors relied upon the existing agreements in extending credit. See In re Credit Industrial Corp., 366 F.2d 402 (C.A. 2, 1966) (hereinafter cited as "CIC"); 3A Collier on Bankruptcy ¶65.06 (14th ed., 1976). See In re National Discount Corp., 212 F. Supp. 929, 933 (W.D. S. Car., 1963): "If a bankrupt were solvent, the [subordination] provision would be meaningless. To deny its validity would destroy a very essential term of the contract * * * ."

There is no reason why subordination agreements should not be enforced in a SIPC liquidation. As the bankruptcy judge noted, the agreements in this case were expressly subordinated to the claims of general creditors in the event of bankruptcy.

Subordinated loans were, and continue to be, widely used to finance commercial enterprises, 30/ as well as securities brokers, and there are

29/ In order to qualify as a satisfactory subordination agreement under the then existing rules, the written agreement had to subordinate the lender's right to demand the return of the securities or repayment of the loan to the rights of all present and future creditors. 17 CFR 240.15c3-1(c)(7)(i). The agreement had to provide that the cash or securities must be loaned to the broker by the lender for not less than one year and must be used as part of the capital of the business and subject to its risks. 17 CFR 240.15c3-1(c)(7)(ii), (vi). The agreement could not contain an acceleration of maturity in the event of any default. 17 CFR 240.15c3-1(c)(7)(iv). And, finally, all written evidence of such indebtedness had to indicate clearly that it is subject to the provision of a subordination agreement. 17 CFR 240.15c3-1(c)(7)(v). These requirements have been preserved and further amplified by the current Rule 15c3-1d.

30/ See CIC, supra, 366 F.2d at 410, where this Court noted that subordination agreements infuse billions of dollars into commercial enterprises.

numerous inducements for a lender to subordinate his loan. The lender is deemed to be the beneficial owner of the money and property and thus is entitled to all accretions, such as dividends or interest payments, which might accrue to it. In addition, under the agreement, the lender normally receives interest at a rate higher than that usually carried by an advance to a broker-dealer.

Customers, on the other hand, are not subject to the same financial incentives and typically do not intend to assume the business risk of financial irresponsibility of their broker-dealer. In re John W. Yeaman, Inc., Securities Exchange Act Release 7527 (Feb. 10, 1965); In re Guy D. Marianne, 11 S.E.C. 967, 970-71 (1942). For these reasons, customers have been singled out by Congress, by the Commission, and by the self-regulatory organizations for special protection from that risk through the financial responsibility rules and the limited protection provided by SIPA. ^{31/}

The subordinated lenders of Weis expressly agreed to subordinate their claims to those of customers and of general creditors in the event of liquidation. They should be allowed to recover their advances only in accordance with the terms of their agreements. These lenders were presumably fully cognizant of the fact that for net capital purposes, their loans would be included in net assets and would not be considered part of Weis' liabilities. The loans thus would create an appearance of financial solvency upon which customers could properly rely.

- B. Public policy requires that customer reliance on the rules relating to the financial responsibility of broker-dealers be presumed. Therefore, the subordination agreements used to meet Weis' net capital requirements must be enforced insofar as the claims of Weis' customers are concerned.

Members of the public must be deemed to rely on state or federal regulations

^{31/} Cf. Arneil v. Ramsey, 550 F.2d 774, 783 (C.A. 2, 1977).

regulations specifically designed for their protection. ^{32/} As we have seen, the policy underlying the Commission's net capital rule, and necessarily underlying subordination agreements, is that such advances to a brokerage firm cannot be withdrawn, by mutual consent or otherwise, if such withdrawal would result in a violation of the minimum net capital ratio required by the rule. As noted above (page 8), a broker-dealer which fails to comply with the net capital requirements is not permitted to deal with the public and may be liquidated.

Because a broker-dealer failing to meet the net capital requirements is required to answer to both the Commission and a self-regulatory organization, customers have a right to assume the integrity of subordination agreements providing for the subordinated capital to be available for their benefit. Securities and Exchange Commission v. Kelly Andrews & Bradley, Inc., 341 F. Supp. 1201, 1208 (S.D. N.Y., 1972). Thus, as the district court properly held, even though a customer of Weis may not have been actually aware of the existence of, nor appreciated the importance of, the subordination agreements to the safety of his account, he may be presumed to have relied on the fact that the financial responsibility of Weis was monitored by the regulatory authorities.

A requirement that actual reliance must be proved at an evidentiary hearing would exacerbate the problem of impermanent capital in the brokerage community, which was recognized as an important cause of broker-dealer failures during the 1969-1970 period, with the consequent loss of customer funds. Study of Unsafe and Unsound Practices at 49. If rescission were to be permitted, there would be continuing uncertainty as to the financial responsibility of broker-dealers whose

^{32/} Cf. Arneil v. Ramsey, *supra*, 550 F.2d at 783; Securities and Exchange Commission v. First Securities Co. of Chicago, 463 F.2d 981, 988 (C.A. 7), certiorari denied *sub nom. McKy v. Hochfelder*, 409 U.S. 880 (1972); Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 142-143 (C.A. 7, 1969).

capital rests, in part and often in large part, on subordination agreements, 33/ and consequent uncertainty as to the amount of capital available for the protection of investors and creditors. To permit rescission of subordination agreements in contravention of a policy carefully constructed to protect customers and promote the financial health of the market could severely undermine the confidence of the marketplace in the ability of the Commission to regulate broker-dealers and detect financially weak brokerage firms.

The appellants urge (Joint Brief 39-42) that this Court's decision in CIC, supra, 366 F.2d 402, precludes summary judgment because of the necessity of holding a hearing on the factual issue of creditors' reliance on the capital cushion provided by the subordinated loans. But, as noted by the district judge (A417-418), CIC, did not involve an industry that, as in this case, is subject to comprehensive federal regulation specifically aimed at protecting a class of public investors.

33/ The following chart indicates the percentage of total capital represented by subordinated loans to New York Stock Exchange members during the approximate period the subordination agreements involved herein were used by Weis.

COMPOSITION OF NYSE MEMBER
FIRMS' CAPITAL FUNDS (YEAR END 1968-70)

Subordinated loans and accounts as a percentage of total capital	All firms		
	1968	1969	1970
0.....	193	162	134
01 to 9.9.....	54	44	38
10 to 19.9.....	49	43	30
20 to 29.9.....	21	23	25
30 to 39.9.....	20	33	27
40 to 49.9.....	21	22	22
50 to 59.9.....	16	19	19
60 to 69.9.....	8	13	25
70 and over.....	3	20	13
Total	385	379	333

Source: NYSE I & E reports, Office of Policy Research.

Study of Unsafe and Unsound Practices at 57.

Rather, that case involved subordination agreements between a small group of institutional creditors and a finance company where the parties actually negotiated their contractual rights. Moreover, the subordinated loans in CIC were not held out as capital and were not required by law to permit the company to qualify to do business with the public.

When the subordinated lender alleges that he was fraudulently induced to enter into a lending agreement, the court should apply equitable principles to determine which of the parties must bear the loss caused by the debtor. CIC, supra, 366 F.2d at 409. Equitable considerations require that the subordinated loan agreements involved in this case be enforced, even if they were procured by fraud. As the court stated in In re National Discount Corp., 212 F. Supp. 929, 933 (W.D. Car. 1963):

"There is no reason in law or equity, why the contractual rights of creditors who come within the subordination provisions would not be recognized and enforced in bankruptcy. To hold otherwise would * * * strike down rights which these [senior] creditors acquired in good faith, for full value and without notice of any infirmity in the contracts * * * ."

As between the subordinated lenders who claim to have been fraudulently induced by Weis and customers and other creditors, the lenders, who dealt with Weis and thereby enabled the firm to remain in business longer than it should have, to the ultimate detriment of its customers and creditors, have a less meritorious claim in an equity court for relief than do those customers and creditors. See 2 Pomeroy, Equity Jurisprudence §397.

C. The remedy of rescission is generally inapplicable in liquidations where, as here, the funds or securities with which a creditor has been fraudulently induced to part cannot be identified or traced. To the extent that a subordinated lender has any claim, it could only be a tort claim for fraud.

1. Rescission, as such, is not available in this case because of the impossibility of restoring the parties to the status quo ante.

Rescission is an equitable remedy available to a party who is induced into entering into a contract or other transaction by another's fraudulent misrepresentations. The court, in its discretion, may afford the victim of such a

fraud the right to avoid the transaction in its entirety and enable him to sue for damages. ^{34/} The court will grant rescission, however, only where the parties can be restored to the status quo ante. ^{35/} Unlike the situation where a creditor is unaware of having entered into an agreement and the court views the transaction as if it had never occurred, rescission is based on the "principle, that, as the transaction ought never to have taken place, the parties are to be placed as far as possible in the situation in which they would have stood if there had never been any such transaction." ^{36/}

The party seeking to rescind or reclaim has the burden of showing that the property has not been dissipated or otherwise disposed of. Where the property is not in the custody or control of the bankrupt at the date of bankruptcy, or where the property sought to be reclaimed cannot be specifically traced or identified, ^{37/} it is impossible to place the parties in the status quo ante. To permit rescission or restitution under those circumstances would give a

^{34/} Morris Plan Industrial Bank of New York v. Schorn, 135 F.2d 538 (C.A. 2, 1943); United Forest Products Co. v. Baxter, 452 F.2d 11 (C.A. 8, 1971); Lummus Co. v. Commonwealth Oil Refining Co., 280 F.2d 915 (C.A. 1), certiorari denied 364 U.S. 911 (1960); Ettlinger v. National Surety Co., 221 N.Y. 467, 117 N.E. 945 (1917); Cf. Arnell v. Ramsay, supra, 550 F.2d at 783.

^{35/} Grymes v. Sanders, 93 U.S. 55, 62 (1876) "A court of equity is always reluctant to rescind, unless the parties can be put back in statu quo. If this cannot be done, it will give such relief only where the clearest and strongest equity imperatively demands it. Here the appellant received the money paid on the contract in entire good faith. He parted with it before he was aware of the claim of the appellees, and cannot conveniently restore it."

^{36/} Pan American Petroleum and Transport Co. v. United States, 273 U.S. 456, 505 (1927). See also Moore v. Crawford, 130 U.S. 122 (1889).

^{37/} Cunningham v. Brown, 265 U.S. 1, 11 (1924); In re Equity Funding Corporation of America, 416 F. Supp. 132, 150 (C.D. Cal., 1975).

creditor an undue preference. 38/

Under the circumstances of this case, rescission is not possible since, so far as we are aware, neither the money nor the securities in question were in the possession or control of Weis at the date that the SIPC trustee was appointed. But, even if it were possible to identify specific items or funds as belonging to a subordinated lender who claims to have been fraudulently induced to subordinate his loan, a court should not exercise its discretion to grant rescission when the broker-dealer is in a SIPC liquidation and claims of third-party creditors against such assets have arisen.

2. If a subordinated lender is to have any remedy in this case, it could be only as the holder of a tort claim for fraud. He could participate on that claim in the Weis estate, if at all, only with the claims of non-customer creditors after customer claims have been satisfied.

Courts have held that one who has been fraudulently induced by a broker-dealer to purchase valueless securities does not have a claim as a "customer" under SIPA §6(c)(2)(A)(ii). In Securities and Exchange Commission v. S. J. Salmon & Co., Inc., 375 F. Supp. 657, 870-871 (S.D. N.Y., 1974), the district judge agreed with the bankruptcy judge's conclusion that such a person "could bring the fraud claim as a general creditor which, if allowed, would be satisfied out of [the bankrupt's] general estate." 39/

38/ As the court stated in Kamberg v. Springfield National Bank, 199 N.E. 339, 341 (Mass., 1935):

"[T]hat principle [rescission] applies only so long as the money or property can be traced and found * * *. When that can no longer be done, the claim of the person who has been deprived of money or property by fraud or other tort * * * ranks no higher than the claims of ordinary creditors * * * the transfer is a preference * * *."

See also Malone v. Gimpel, 151 F. Supp. 549, 554 (N.D. N.Y., 1956), affirmed, 244 F. 2d 954 (C.A. 2, 1957); Morris Plan Industrial Bank of New York v. Schorn, 135 F.2d 538 (C.A. 2, 1943); Sections 60a(1) and 70e(1) of the Bankruptcy Act, 11 U.S.C. 96a(1) and 110e(1).

39/ Cf. Securities and Exchange Commission v. Kenneth Bove & Co., Inc., 378 F. Supp 697, 700 (S.D. N.Y. 1974); In re Los Angeles Land and Investments, Ltd., 282 F. Supp. 448 (D. Hawaii, 1968), affirmed per curiam, 447 F.2d 1366 (C.A. 9, 1971).

This Court has stated that the purpose of Congress in adopting SIPA was to protect the public "customer as investor and trader, not * * * others who might become creditors of the broker-dealer for independent reasons." Securities and Exchange Commission v. F. O. Baroff Co., Inc., 497 F.2d 280, 283 (1974). In F. O. Baroff Co., the creditor had made a loan to help the broker-dealer "out of a cash bind" (id. at 284) and, accordingly, was held not to be a customer. Similarly, the relationship established in the instant case does not bear "the indicia of the fiduciary relationship between a broker and his public customer, but rather the characteristics of, at most, an ordinary debtor-creditor relationship" (id.). 40/

In order for subordinated creditors to be able to assert fraud claims, this Court must determine whether such claims are provable in a SIPC liquidation. Contingent and unliquidated tort claims are not provable under Section 57(d) of the Bankruptcy Act, 11 U.S.C. 93(d). By contrast to a liquidation, Chapter X of the Bankruptcy Act, 11 U.S.C. 501, et seq., provides a mechanism for a debtor to adjust its liabilities and to continue in business. As the district court stated in In re Los Angeles Land and Investments Ltd., 282 F. Supp. 448 (D. Hawaii, 1968), affirmed per curiam, 447 F.2d 1366 (C.A. 9, 1971):

"Chapter X recognizes the necessity of recognizing claims which might not otherwise be provable in bankruptcy * * *. In keeping with the fundamental purpose of effecting a rehabilitation of a financially embarrassed corporation by the reorganization of its creditor obligations and shareholders' interest, it is essential to discharge all demands of whatever sort, executory and contingent, presently due or to mature in the future." 282 F. Supp at 452.

A SIPC liquidation does not permit rehabilitation as Chapter X contemplates. See SIPA §6(a)(4), 15 U.S.C. 78fff(a)(4). Although a trustee under SIPA has

40/ Accord, Securities Investor Protection Corp. v. Executive Securities Corp., [Current] Fed. Sec. L. Rep. (CCH) ¶96,062 (C.A. 2, 1977).

all the powers of a trustee in bankruptcy or a trustee in a Chapter X proceeding, he must liquidate the broker-dealer and may operate the business only to complete open contractual commitments pursuant to Sections 6(a)(2), 6(d), 15 U.S.C. 78fff(a)(2), (d). Accordingly, Section 57(d) of the Bankruptcy Act should apply in its full force and "an unliquidated or contingent claim [should] not be allowed unless liquidated or the amount thereof estimated in the manner and within the time directed by the court." This Court recently had occasion to interpret this section in In re Cartridge Television, Inc., 535 F.2d 1388, 1391 (1976), where it stated:

"The necessity of providing, as a means of facilitating the prompt distribution of bankrupt estates, that certain types of claims may not be proved has long been recognized. As an obvious example, most tort claims remain non-provable against both corporate and personal bankrupts §63(a)(7), 11 U.S.C. §103(a)(7) * * * despite the fact that no other avenue of recovery may be available to the victim" (citations omitted).

The Court noted, however, that it might be an abuse of discretion for a judge "[t]o reject an easily provable securities fraud claim" (id.).

The claims involved in the instant case are contingent in nature, and it may never be established that there was fraud in the inducement which would enable these claimants to succeed in their claims for damages. But were it possible for these claims to be established and provable, the considerations which preclude participation by the subordinated lenders with the claims of customers are different from those which affect the treatment of non-customers. Weis' non-customer creditors are like creditors of an ordinary business corporation and the special policy considerations embodied in the Securities Exchange Act and SIPA, applicable to customers, would not seem to be applicable to non-customer creditors. Accordingly, insofar as claims for fraud by the subordinated lenders would affect the claims of non-customer creditors, the Court may decide that such lenders may stand in the same position as would a subordinated lender of a

corporation which is not a broker-dealer. Thus, if the appellants are able to establish a fraud claim, they should share in the general estate together only with the claims of Weis' non-customer creditors. 41/ But we understand that, on the facts of the present case, even if the subordinated lenders were to share on their fraud claims in the Weis general estate with the claims of non-customer creditors, they would not receive any payment, since all the money allocable to them on the initial computation would be needed to satisfy the customers' claims.

41/ A somewhat similar approach has been followed, and supported by the Commission, in reorganization proceedings under Chapter X of the Bankruptcy Act, 11 U.S.C. 501, et seq., not involving broker-dealers, where defrauded shareholders of insolvent companies have participated in the estate on a parity with the claim of general creditors. See, e.g., In re Four Seasons Nursing Centers of America, Inc., 472 F.2d 747 (C.A. 10, 1973); In re Equity Funding Corporation of America 416 F. Supp. 132, 152-154 (C.D. Cal., 1975); the Supreme Court did not reach the issue in Protective Committee v. Anderson, 390 U.S. 414 (1968). See also, the Commission's Report on Proposed Bankruptcy Legislation, printed in Hearings before the House Subcommittee on Civil and Constitutional Rights on H.R. 31 and H.R. 32, 94th Cong., 2d Sess., 2164, 2184-2186 (1976). The participation by defrauded stockholders as creditors under a Chapter X plan has resulted from compromises reached among the various classes of creditors and the trustee.

CONCLUSION

For the foregoing reasons, the judgment of the district court should be affirmed insofar as it held that the claims of the subordinated lenders could not share in the Weis estate with the claims of customers, even if the subordination agreements had been fraudulently induced.

Respectfully submitted,

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